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DIRECTORS' REPORT

H₂O ENTERTAINMENT CORP.

Consolidated Financial Statements

For the years ended December 31, 1997 and 1996

Dick Cook Schull
CHARTERED ACCOUNTANTS

DICK COOK SCHULLI

Chartered Accountants

Accountants for 1997 and 1996

AUDITORS' REPORT

To the Shareholders of H₂O Entertainment Corp.

We have audited the consolidated balance sheets of H₂O Entertainment Corp. as at December 31, 1997 and 1996 and the consolidated statements of loss and deficit and changes in financial position for the years then ended. These consolidated financial statements are the responsibility of the corporation's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the corporation as at December 31, 1997 and 1996 and the results of its operations and the changes in its financial position for the years then ended in accordance with generally accepted accounting principles.

Calgary, Alberta
May 12, 1998

Dick Cook Schulli

CHARTERED ACCOUNTANTS

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Professional Corporation

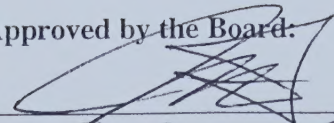
H₂O ENTERTAINMENT CORP.

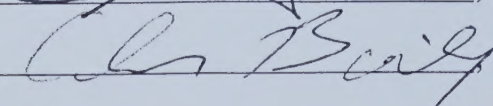
Consolidated Balance Sheets

As at December 31, 1997 and 1996

	<u>1997</u>	<u>1996</u>
Assets		
Current		
Cash	\$ 24,886	\$ 483,825
Accounts receivable	9,557	19,419
Income taxes recoverable	48,475	48,475
Prepaid expenses and deposits	13,107	26,658
Deferred income taxes	-	47,301
Development costs	-	919,758
	<u>96,025</u>	<u>1,545,436</u>
Excess of cost over net identifiable assets acquired - Note 3	198,000	264,000
Capital - Note 4	<u>466,995</u>	<u>382,669</u>
	<u>\$ 761,020</u>	<u>\$ 2,192,105</u>
Liabilities		
Current		
Accounts payable and accrued liabilities	\$ 30,790	\$ 52,142
Deferred revenue	-	1,025,930
Due to a shareholder	<u>56,478</u>	<u>-</u>
	<u>87,268</u>	<u>1,078,072</u>
Shareholders' Equity		
Share capital - Note 5	1,788,077	1,647,470
Deficit	<u>(1,114,325)</u>	<u>(533,437)</u>
	<u>673,752</u>	<u>1,114,033</u>
	<u>\$ 761,020</u>	<u>\$ 2,192,105</u>

Approved by the Board:


_____, Director


_____, Director

See accompanying notes

H₂O ENTERTAINMENT CORP.

Consolidated Statement of Loss and Deficit

For the years ended December 31, 1997 and 1996

	<u>1997</u>	<u>1996</u>
Revenue		
Royalty income	\$ 1,458,623	\$ -
Cost of game development	<u>1,317,116</u>	<u>-</u>
	<u>141,507</u>	<u>-</u>
Expenses		
Amortization - capital assets	25,657	26,603
- excess purchase cost	66,000	66,000
Administration and investor relations	187,587	186,697
Research costs	<u>443,151</u>	<u>-</u>
	<u>722,395</u>	<u>279,300</u>
Loss before income taxes	<u>580,888</u>	<u>279,300</u>
Income taxes (recovery) - Note 7		
Current	-	(96,950)
Deferred	<u>-</u>	<u>194,267</u>
	<u>-</u>	<u>97,317</u>
Net loss	580,888	376,617
Deficit, beginning of year	533,437	83,775
Premium paid on redemption of share capital	<u>-</u>	<u>73,045</u>
Deficit, end of year	<u>\$ 1,114,325</u>	<u>\$ 533,437</u>
Loss per share	<u>\$ 0.06</u>	<u>\$ 0.05</u>

See accompanying notes

H₂O ENTERTAINMENT CORP.

Consolidated Statement of Changes in Financial Position

For the years ended December 31, 1997 and 1996

	<u>1997</u>	<u>1996</u>
Cash provided by (used for):		
Operating activities		
Net loss	\$ (580,888)	\$ (376,617)
Amortization	<u>158,807</u>	<u>92,603</u>
	(422,081)	(284,014)
Net changes in non-cash working capital items	<u>9,190</u>	<u>(641,367)</u>
	<u>(412,891)</u>	<u>(925,381)</u>
Financing activities		
Shares issued	140,607	1,545,145
Redemption of shares	-	(75,000)
Share issue costs	-	(91,607)
Reverse takeover transaction - Note 1	-	181,878
Shareholder advances (repayments)	<u>56,478</u>	<u>(16,838)</u>
	<u>197,085</u>	<u>1,543,578</u>
Investing activities		
Capital assets acquired	<u>(243,133)</u>	<u>(160,477)</u>
Increase (decrease) in cash	(458,939)	457,720
Cash, beginning of year	<u>483,825</u>	<u>26,105</u>
Cash, end of year	<u>\$ 24,886</u>	<u>\$ 483,825</u>

See accompanying notes

H₂O ENTERTAINMENT CORP.

Notes to Consolidated Financial Statements

For the years ended December 31, 1997 and 1996

Note 1 - General

Description of business and reverse takeover

H₂O Entertainment Corp. ("the corporation"), was incorporated pursuant to the provisions of the Business Corporations Act (Alberta) on March 9, 1992 as 521729 Alberta Inc. The corporation amended its articles to change its name to Computer Experts Inc. on May 12, 1992. On October 19, 1995, the corporation again amended its articles, changing its name to H₂O Entertainment Ltd. and at the same time amending its authorized share capital.

The corporation carried on business as a supplier and installer of computer hardware until December 1994. In 1993, through its wholly-owned subsidiary, H₂O Design Inc., the corporation commenced its current business of software development specializing in the video game and entertainment sector.

On June 5, 1996, Canadian Entech (Entech) acquired all of the issued and outstanding shares of the corporation in exchange for the issuance of common shares to the shareholders of the corporation on a one for one basis. The net effect resulted in the former shareholders of the corporation receiving 77.8% of the issued and outstanding common shares of Entech. On June 11, 1996, the corporation change the name to H₂O Entertainment Corp.

This transaction is commonly referred to as a reverse takeover and has been accounted for using the purchase method. Therefore, in accordance with generally accepted accounting principles, the corporation is treated as the acquired and Entech is deemed to be a continuation of the corporation and comparative figures for the prior period are those of the corporation.

A summary of net assets acquired and consideration given in the acquisition of Entech are as follows:

Net assets acquired:	
Current assets	\$ 13,703
Current liabilities	<u>(161,825)</u>
	<u>\$ (148,122)</u>
Consideration given:	
Common shares	<u>\$ 181,878</u>
Excess of cost over net identifiable assets acquired	<u>\$ 330,000</u>

H₂O ENTERTAINMENT CORP.

Notes to Consolidated Financial Statements

For the years ended December 31, 1997 and 1996

Note 2 - Significant Accounting Policies *(Continued)*

The financial statements of the corporation have been prepared in accordance with generally accepted accounting principles. Because a precise determination of many assets and liabilities is dependent upon future events, the preparation of periodic financial statements necessarily involves the use of estimates and approximation. The financial statements have, in management's opinion, been properly prepared within reasonable limits of materiality and within the framework of the significant accounting policies summarized below.

(a) Consolidation

The consolidated financial statements include the accounts of H₂O Entertainment Corp. and its wholly-owned subsidiaries, H₂O Entertainment Ltd. and H₂O Design Inc.

(b) Capital assets and amortization

Capital assets are recorded at cost. Amortization of these assets is provided using rates designed to amortize their cost over their estimated useful lives at the following annual rates:

Development equipment:

Computer hardware	30% declining balance
Computer software	50% declining balance
Sound and audio equipment	30% declining balance

Other:

Automotive	30% declining balance
Office furniture and fixtures	20% declining balance
Leasehold improvements	straight-line over lease term

In the year of acquisition, amortization is reduced by one-half.

(c) Excess of cost over net identifiable assets acquired

The excess of cost over net identifiable assets acquired is being amortized on a straight-line basis over 5 years.

(d) Foreign currency translation

Monetary assets and liabilities are translated at the rates of exchange at the balance sheet dates. Non-monetary assets and liabilities are translated at the rates in effect at the dates the assets or liabilities were acquired. Revenues and expenses are translated at the average rates of exchange during the month in which they are recognized. During the year, there were no gains or losses.

H₂O ENTERTAINMENT CORP.

Notes to Consolidated Financial Statements

For the years ended December 31, 1997 and 1996

Note 2 - Significant Accounting Policies *(Continued)*

(e) Leases

The corporation accounts for leases that transfer significant benefits of ownership as capital acquisitions and corresponding liability obligations. Leases that do not transfer significant benefits of ownership are classified as operating leases.

(f) Revenue recognition

The corporation recognizes revenue from royalty agreements as follows:

- (1) **Royalty guarantees** - when the corporation receives certification of approval from its publisher.
- (2) **Additional royalties** - Royalties in excess of any royalty guarantees are recognized upon receipt of documentation of unit sales.

In the circumstance where the corporation receives advance royalty payments under a Software Development Agreement and the payments received are not refundable, they are classified as deferred revenue until approval of the game software is received. When game software approval is expected in the next fiscal year, the deferred revenue is classified as a current liability and the related deferred costs is classified as a current asset.

(g) Development costs

The corporation capitalizes and defers all costs directly related to the development of project software once technical feasibility has been determined. These costs include all salaries, consulting fees, administration and amortization of capital assets used directly in the development of specific project software. Any incidental revenue, including interest, reduces the amounts capitalized.

The corporation charges these costs to operations over the same period as the related royalty guarantees.

In the event that a software development project is abandoned or deemed not to be commercially viable, the total of the deferred costs for this project will be expensed at that time.

Prior to technical feasibility, these costs are expensed in the period incurred as research costs.

H₂O ENTERTAINMENT CORP.

Notes to Consolidated Financial Statements

For the years ended December 31, 1997 and 1996

Note 2 - Significant Accounting Policies (Continued)

(h) Income taxes

The corporation follows the tax deferral method in providing for income taxes, whereby the income tax provision is based on the income reported in the accounts. Under this method, deferred income taxes arise as a result of including royalties received in taxable income and deducting current development costs incurred and of providing for amortization for income tax purposes on a different basis than for accounting purposes. Deferred income taxes are provided for on these differences at current income tax rates.

(i) Loss per share

Loss per share figures are based on the weighted number of shares outstanding in the year.

Note 3 - Excess of Cost Over Net Identifiable Assets Acquired

	<u>1997</u>	<u>1996</u>
Excess of cost over net identifiable assets acquired		
on reverse takeover of Entech	\$ 330,000	\$ 330,000
Less accumulated amortization	<u>(132,000)</u>	<u>(66,000)</u>
	<u>\$ 198,000</u>	<u>\$ 264,000</u>

Note 4 - Capital Assets

	<u>1997</u>		<u>1996</u>
	<u>Cost</u>	<u>Accumulated Amortization</u>	<u>Net Book Value</u>
Development equipment:			
Computer hardware	\$ 506,295	\$ 177,724	\$ 328,571
Computer software	136,588	96,324	40,264
Sound and audio equipment	<u>44,793</u>	<u>22,233</u>	<u>22,560</u>
	<u>687,676</u>	<u>296,281</u>	<u>391,395</u>
Other:			
Office furniture and equipment	66,598	28,078	38,520
Leasehold improvements	<u>82,376</u>	<u>45,296</u>	<u>37,080</u>
	<u>148,974</u>	<u>73,374</u>	<u>75,600</u>
	<u>\$ 836,650</u>	<u>\$ 369,655</u>	<u>\$ 466,995</u>
			<u>\$ 382,669</u>

H₂O ENTERTAINMENT CORP.

Notes to Consolidated Financial Statements

For the years ended December 31, 1997 and 1996

Note 5 - Share Capital

Authorized:

30,000,000 Class A common voting shares

Issued and outstanding:

	1997		1996	
	Shares	Amount	Shares	Amount
Balance , beginning of year	8,832,271	\$ 1,647,470	5,700,000	\$ 14,009
Issued for services	50,000	25,000	-	-
Redemption and cancellation	-	-	(700,000)	(1,955)
Issued in conjunction with private placements	100,000	100,000	1,814,500	1,507,645
Shares issued to Entech shareholders - Note 1	-	-	1,942,771	181,878
Issued on exercise of stock options	<u>226,000</u>	<u>62,908</u>	<u>75,000</u>	<u>37,500</u>
		1,835,378		1,739,077
Share issue costs		-		(138,908)
Tax benefits (reversals of share issue costs)		<u>(47,301)</u>		<u>47,301</u>
Balance , end of year	<u>9,208,271</u>	<u>\$ 1,788,077</u>	<u>8,832,271</u>	<u>\$ 1,647,470</u>

(a) Redemption and cancellation

On January 15, 1996, the corporation redeemed 700,000 Class A common shares owned by a former director and officer for cash consideration of \$75,000. The aggregate paid up capital of the redeemed shares was \$1,955. The premium on redemption has been charged to retained earnings.

(b) Escrowed common shares

As at December 31, 1997, there are a total of 3,420,833 shares that remain held under escrow agreements dated June 5, 1996. The escrow agreement provides that 1,250,000 escrowed shares be released as to one-third thereof upon the first, second and third anniversaries of the completion date of the reverse takeover transaction dated June 5, 1996 (Note 1) and the remaining 2,587,500 shares will be released from escrow on the basis of one escrowed share for each \$0.25 of cash flow of the corporation.

During the year, 416,667 shares were released from escrow based on the June 5, 1996 anniversary plus an additional 862,500 were released upon game approval.

H₂O ENTERTAINMENT CORP.

Notes to Consolidated Financial Statements

For the years ended December 31, 1997 and 1996

Note 5 - Share Capital *(Continued)*

(c) Stock options

As at December 31, 1997, the corporation has outstanding stock options issued to directors, officers and employees, convertible into common shares on a one for one basis, as follows:

<u>Number of Options</u>	<u>Exercise Price</u>	<u>Expiry Date</u>
225,000	\$ 0.50	June 2001
135,000	\$ 1.00	June 2001
145,000	\$ 1.00	July 2002
145,000	\$ 1.12	July 2002

(d) Tax benefits of share issue costs

In 1996 the tax benefits of share issue costs were recorded. In the current year they have been reversed as it is not certain they will ever be realized.

Note 6 - Commitments

The corporation has entered into a premises operating lease agreement, expiring in July 2000, with the estimated annual lease payment of \$42,600

Note 7 - Income Taxes

At December 31, 1997 the Corporation has losses forward of approximately \$520,000 for income tax purposes. These losses expire in 2004. No provision has been made for the benefit of these losses as there is no certainty that these losses will be utilized.

